

**DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS: 02-980523
Indiana Adjusted Gross Income Tax
For Tax Years 1993 and 1994**

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ISSUE

I. Adjusted Gross Income Tax: Business/Non-Business Income and I.R.C. § 338(h)(10) Elections

Authority: I.R.C. §338(h)(10); IC 6-8.1-5-1(f); IC 6-3-1-20; 45 IAC 15-5-5; 45 IAC 3.1-1-37; 26 Ind. Reg. 580 (Ind. Dept. of Revenue 2002); May Dept. Stores Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); McVean & Barlow v. New Mexico Bureau of Revenue, 543 P.2d 489 (N.M. Ct. App. 1975); Laurel Pipe Line Co. v. Board of Fin. & Revenue, 642 A.2d 472 (Pa. 1994); Polaroid Corp. v. Offerman, 507 S.E.2d 284 (N.C. 1998); Lenox Inc. v. Offerman, 538 S.E.2d 203 (N.C. Ct. App. 2000); Lenox, Inc. v. Tolson, 548 S.E.2d 513 (N.C. 2001); Kemppel v. Zaino, 746 N.E.2d 1073 (Ohio 2001); Blessing/White Inc. v. Zehnder, 768 N.E.2d 332 (Ill. App. Ct. 2002); Texaco-Cities Serv. Pipeline Co. v. McGaw, 695 N.E.2d 481 (Ill. 1998); Welded Tube Co. v. Commonwealth, 515 A.2d 988 (Pa. Commw. Ct. 1986).

Taxpayer protests the characterization of gain derived from a deemed asset sale as business income.

STATEMENT OF FACTS

AC (Acquiring Corporation) purchased the stock of TC (Target Corporation) from PC (Parent Corporation of Target). AC and PC made an I.R.C. §338(h)(10) election for federal income tax purposes. By making the election, AC and PC could treat the sale of TC stock as a sale of TC's assets, with TC recognizing a taxable gain. The Department characterized the gain as business income subject to 45 IAC 3.1-1-37 formulary apportionment rules. TC (our taxpayer) took the position the Department should properly characterize the gain as allocable non-business income.

Taxpayer's ensuing protest proved unsuccessful. See 26 Ind. Reg. 580 (Ind. Dept. of Revenue 2002). Pursuant to IC 6-8.1-5-1(f) and 45 IAC 15-5-5, taxpayer requested and the Department granted a rehearing. The results of which now follow.

DISCUSSION

I. Adjusted Gross Income Tax: Business/Non-Business Income and I.R.C. § 338(h)(10) Elections

Taxpayer summarized the Department's position in its Request for Rehearing as:

In 26 Ind. Reg. 580 (Ind. Dept. of Revenue 2002), the Department held that the gain recognized on the deemed sale of Taxpayer's assets as a result of an I.R.C. §338(h)(10) election is properly classified as business income subject to apportionment under the functional test set forth in IC 6-3-1-20....

Taxpayer previously argued the Department improperly classified the "gain" in question as business income subject to formulary apportionment. The taxpayer explained:

[T]he deemed sale of its assets was an extraordinary, non-recurring event that was neither a necessary nor an essential part of [t]axpayer's regular trade or business operations. The [deemed asset sales] transaction could not be a necessary and essential part of [t]axpayer's regular trade or business operations...because the [deemed] disposition of the assets...terminated [taxpayer's business operations]. As a result of this [I.R.C. § 338(h)(10)] election between the [] Buyer and [] Seller, Taxpayer is deemed to sell all of its assets in liquidation of its business and immediately distribute the proceeds from the deemed sale to its parent corporation in liquidation of its corporate existence. Under the construct of I.R.C. §338(h)(10), the funds are treated as if they were distributed in liquidation because the funds are in fact received by...the actual seller.

Taxpayer now argues that "[t]he disposition of [an] entire business cannot be considered an integral part of the taxpayer's regular trade or business." To support its conclusion, the taxpayer directs the Department's attention to other jurisdictions. According to the taxpayer, there exists a line of cases which stand for the proposition that proceeds derived from the complete liquidation of an entire business and proceeds derived from the liquidation of a "separate and distinct aspect" of a business represent nonbusiness income if such proceeds are distributed to shareholders. See McVean & Barlow v. New Mexico Bureau of Revenue, 543 P.2d 489 (N.M. Ct. App. 1975); Laurel Pipe Line Co. v. Board of Fin. & Revenue, 642 A.2d 472 (Pa. 1994); Polaroid Corp. v. Offerman, 507 S.E.2d 284 (N.C. 1998); Lenox Inc. v. Offerman, 538 S.E.2d 203 (N.C. Ct. App. 2000); Lenox, Inc. v. Tolson, 548 S.E.2d 513 (N.C. 2001); Kemppel v. Zaino, 746 N.E.2d 1073 (Ohio 2001); Blessing/White Inc. v. Zehnder, 768 N.E.2d 332 (Ill. App. Ct. 2002); But c.f., Texaco-Cities Serv. Pipeline Co. v. McGaw, 695 N.E.2d 481 (Ill. 1998) (proceeds derived from partial liquidation deemed business income because sale did not result in cessation of any particular line of business and sale proceeds were reinvested in the company); Welded Tube Co. v. Commonwealth, 515 A.2d 988 (Pa. Commw.

Ct. 1986) (proceeds from sale of manufacturing facility characterized as business income under the functional test because the closing of the facility did not lead to a cessation of taxpayer's manufacturing operations and the "[g]ain from the sale was invested in on-going operations").

Taxpayer further argues "[t]here is no basis in law or logic for treating a deemed liquidation under §338(h)(10) differently from an actual liquidation." Taxpayer explains:

The target [TC] is treated, under §338(h)(10), as if it sold all of its assets, went out of business, and liquidated. This is precisely the type of liquidation contemplated by the court cases. Whether the buyer continues the business or uses the assets in another business is of no consequence. The point is that taxpayer has liquidated its business.

Therefore, since the "[t]axpayer is treated as liquidating its corporate existence for all income tax purposes as a result of the I.R.C. §338(h)(10) election," the gain from the deemed sale of assets, fails to qualify as business income under the functional test.

The Issue:

At issue is whether TC's gain is taxable under I.C. 6-3-1-20. Taxpayer argues the income derived from the "deemed" asset sale represents allocable non-business income. The Department, on the other hand, contends this income represents business income subject to apportionment. Both parties agree resolution of the legal issue depends on whether the income derived from an I.R.C. §338(h)(10) transaction meets the IC 6-3-1-20 definition of "business income." Specifically, resolution depends on whether the aforementioned income qualifies as business income under the functional test.

Indiana "business income":

IC 6-3-1-20 provides "[t]he term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." The Indiana Tax Court recognized the language of IC 6-3-1-20 to include both a "transactional" and a "functional" test. The court in May Dept. Stores Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651, 665 (Ind. Tax Ct. 2001) stated:

The language and structure of IND.CODE § 6-3-1-20 supports the conclusion that the [Indiana] General Assembly intended to define business income via application of both a transactional and functional test. The Court agrees with the Oregon Supreme Court [see Willamette Indus. v. Department of Revenue, 15 P.3d 18 (Or. 2000)] that the functional test requires that the disposition of the assets at issue must, along with their acquisition and management, constitute an integral part of the taxpayer's regular trade or business operations.

The May court explained that business income includes both: (1) income derived from transactions conducted in the regular course of taxpayer's trade or business; and/or (2) income derived from the acquisition, management, and disposition of the property that constitutes integral parts of the taxpayer's regular trade or business operations." Id. at 655. The former represents the transactional test and the latter, the functional test.

Using the functional test, the May court held:

Associated [predecessor of taxpayer] divested an entire division for the benefit of a competitor pursuant to a court order. This divestiture was not an essential part of its department store retailing operations. Associated [predecessor of taxpayer], through all of its divisions, including Horne, was engaged in the business of department store retailing. The *disposition* of Horne's assets was neither a necessary nor an essential part of Associated's department store retailing business operations. Horne was unquestionably an integral part of Associated's business operations. Indeed, Horne was being expanded at the time May [taxpayer] acquired Associated's stock. ***However, pursuant to the [Stipulation and] Order, the divestiture of Horne's assets was for the benefit of a competitor and not for the benefit of Associated. Under these circumstances, this divestiture (or disposition of assets) could not have constituted an integral part of Associated's regular trade or business operations.*** See Laurel PipeLine Co v Board of Fin. & Revenue, 642 A.2d 472, 475-476 (Pa. 1994) (citing McVean & Barlow v. New Mexico Bureau of Revenue, 543 P.2d 489 (N.M. Ct. App. 1975)). ***Therefore, the gains from the sale of Horne's assets did not qualify as business income under the functional test.*** Id. at 665. (Emphasis added.)

The Court further reasoned, "it is not enough that the property was used to generate business income for the taxpayer prior to its disposition. The disposition must be an integral part of the taxpayer's regular trade or business operations." Id. at 664.

Legal Analysis:

Taxpayer presumes Indiana recognizes the validity of the proposition that income derived from a sale of assets previously used to generate apportionable business income is allocable non-business income, in the context of a complete or partial liquidation. Nothing in IC 6-3-1-20 or the May case suggest such a presumption. Under May, the language of IC 6-3-1-20 establishes two tests to determine whether income is "business income". A third test does not exist. The Department only justifies the characterization of income as "business income" when the transactional test or the functional test is met.

Income qualifies as "business income" for the functional test when the income originates from tangible and intangible property, and the acquisition, management, and disposition of such property represent "integral parts of the taxpayer's regular trade or business operations". IC 6-3-1-20. "[I]t is not enough that the property was used to generate business income for the

taxpayer prior to its disposition.” May Dept. Stores Co. at 664. “The disposition too must be an integral part of the taxpayer’s regular trade or business operations.” Id. at 664.

Using this language, the Department must consider three factors in its determination of whether a taxpayer’s income qualifies as “business income” under the functional test. The three factors are: (1) whether the acquisition, management, and disposition of the property generated income; (2) whether a disposition occurred; and (3) whether the acquisition, management, and disposition of the property constituted an integral part of the taxpayer’s trade or business.

The first factor of the functional test involves examining whether the taxpayer, prior to the sale, used the transferred property in its business to produce income. Before the sale, the taxpayer’s assets generated business expenses, deductions, and produced substantial income. After the disposition, the assets retained these business characteristics. The taxpayer continued using the assets and the assets continued generating expenses, deductions, and income.

The second factor of the functional test involves looking at the intent of the taxpayer with respect to the disposition. In May, the court examined the taxpayer’s intent with respect to the disposition by making note of the following facts:

- (1) **The Stipulation and Order (Order) required** May to “divest all of the assets and interests” of Horne.
- (2) Associated (prior to its merger into May) **divested** an entire division for the benefit of a competitor *pursuant to a court order*.
- (3) **Pursuant to the Order**, the divestiture of Horne’s assets was for the benefit of a competitor and not for the benefit of Associated.

Id. at 654, and 665. (Emphasis added.) Utilizing these facts, May held that the taxpayer’s disposition of business assets were not “an integral [part] of the taxpayer’s regular trade or business operations” because the disposition was legally compelled and not a volitional act. Distinguishing this case from the current taxpayer, the taxpayer’s motive in the disposition of the property was for business reasons and not pursuant to an administrative, legislative, or judicial decision. The taxpayer’s decision to sell its stock, make an I.R.C. §338(h)(10) election, and treat the stock sale as a “deemed asset” sale were all volitional acts. Thus, from these facts it is clear that the taxpayer’s intent was to cause a disposition of the property.

The third factor of the functional test involves looking at the end result of the transaction. By examining the end result of the transaction, the Department can confirm whether the disposed property constituted an integral part of the taxpayer’s business. In May, the court remarked:

[T]he divestiture of Horne’s assets was for the benefit of a competitor and not for the benefit of Associated. Under these circumstances, the divesture (or disposition of assets) could not have constituted an integral part of Associated’s regular trade or business operations.”

Id. at 665. (Emphasis added.) Comparing the analysis used in May to this taxpayer, the taxpayer utilized the proceeds of the asset disposition to further the seller’s (Parent

Corporation) ongoing business operations. That is, the seller (Parent Corporation) reinvested the proceeds in its ongoing business. The seller (Parent Corporation) used (and still uses) the tax attributes (basis adjustment) associated with the disposition to reduce the taxpayer's—and indirectly, the Purchaser's—apportionable business income subject to Indiana adjusted gross income tax. Thus, using an analysis similar to the May court, the disposition benefited the taxpayer and not the purchaser; and therefore, the disposition of the property constituted an integral part of the taxpayer's business operations.

For all the aforementioned reasons, the Department properly characterized the income derived from taxpayer's I.R.C. §338(h)(10) deemed asset sale as IC 6-3-1-20 “business income”.

FINDING

The Department denies the Taxpayer's protest.

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